

Developing regulatory standards

Sections 3, 4 and 28, of the Legal Services Act 2007 place a clear responsibility on the LSB and approved regulators to promote the regulatory objectives and better regulation principles.

This paper discusses how the LSB will gain assurance that regulatory standards and performance are effective.

Views on our approach are welcome by Tuesday 12 July 2011

This paper will be of interest to:

Approved regulators

Providers of legal services

Legal representative bodies

Legal advisory organisations

Other third sector organisations

Consumer groups

Law Schools/universities

Legal academics

Members of the legal profession

Accountancy bodies

Potential new entrants to the ABS market

Think-tanks

Government departments

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Executive Summary

Introduction

1. Much of the work that the Legal Services Board (LSB) has done in the 15 months since assuming our full powers has been focused on developing our strategic framework and, where appropriate, a more detailed approach to individual issues. We have also started to deliver the regulatory part of our role, making decisions on applications to change regulatory arrangements and starting to consider applications for new reserved legal activity designations and preparing for licensing authorities (LAs). In future we may be required to approve new entrants.
2. As an independent oversight regulator, the LSB has a responsibility to ensure that we have a consistent and appropriate approach to the regulation of Approved Regulators (ARs). In our regulatory work we have been mindful to operate in a way which is consistent with the Better Regulation Principles. In particular, we have promoted outcome focused regulation and explained our expectations in terms of both ARs supervision of their regulated community and our oversight of ARs.
3. In order to ensure that we maintain a consistent approach we need to develop a mechanism to satisfy ourselves that all the ARs are acting in way which is consistent with the regulatory objectives, better regulation principles and best regulatory practice. In this paper we are seeking views on the way we plan to approach making such an assessment.
4. This paper highlights the changing nature of legal services and the increasing plurality within the legal services market. This has increased substantially because of changing business models, increased use of technology, greater diversity and variation amongst clients (individual and corporate) and more intense competition. The advent of Alternative Business Structures (ABS) in the legal services market may further increase these trends.
5. This greater plurality within the market produces a greater variation in the risks that regulators must tackle. Modern regulation, as enshrined in the better regulation principles, must focus on these risks in order to regulate in a manner that keeps pace with, encourages, supports and controls these changes so as to underpin the regulatory objectives.

What sort of regulation does the LSB expect from ARs?

6. The LSB and ARs share the statutory responsibility to act and regulate in a manner that promotes the regulatory objectives. The proposal in this consultation is simply that this is likely to be achieved through a focus on four constituent parts of regulation:
 - a. outcomes focused regulation (OFR)
 - b. risk identification framework
 - c. proportionate supervision
 - d. appropriate enforcement strategy.
7. The shift towards OFR is part of wider focus on consumer expectations and outcomes. It would be, at best, disproportionate and probably impossible to design a set of detailed rules that are effective at controlling all the risks that arise in each and every type of legal services firm. An outcomes-focused model is preferred because it places freedom to operate, responsibility for delivery of agreed outcomes and accountability for success squarely with the legal services providers which are, after all, closest to their consumers.
8. If firms are to focus on delivering the outcomes that regulators set out, then regulators must be clear about the level of risk attached to different types of businesses, services and consumers. Thus it is essential that the ARs have in place not only an overarching risk identification framework but also the capability and capacity to profile the risk presented by each regulated entity (and where appropriate individual).
9. It follows from this that ARs should then supervise firms according to risk, deploying the greatest resources at the greatest risks so as to produce acceptable net levels of risk in view of the regulatory objectives. To do this, ARs need to focus on their overall capability and capacity as well as formal governance, systems and processes.
10. No regulatory approach provides for, or guarantees, zero failure. Therefore the regulatory regime must be underpinned by an effective enforcement strategy that encourages compliance, deters non-compliance and punishes transgressions appropriately.
11. The LSB proposes to work with ARs to assess the extent to which both their regulatory framework and its practical implementation is consistent with this overarching framework for modern regulation and compliant with the legislative framework from which it emerges. This, we suggest, should be achieved through an initial self-assessment exercise carried out by each AR. This will give the AR the opportunity to set out its approach to the supervision of its regulated community in the light of this guidance.

12. The output from the self assessment exercise is expected to provide a basis for a range of activities including:
 - a. supervisory discussions between the AR and the LSB
 - b. agreed action plans for the AR to develop its regulatory model and performance
 - c. thematic reviews across the ARs
 - d. supporting the LSB in its regulatory decision making processes.

Next Steps

13. These proposals are designed to embed the Better Regulation Principles across the sector. Through the process of this consultation, the LSB proposes to:
 - a. refine its approach to overseeing regulation
 - b. develop the indicators and criteria from those set out at Annex A
 - c. develop a self-assessment process
 - d. support each AR in completion of the self-assessment process and subsequent action
 - e. review its own relevant rules, procedures and guidance to ensure they are compliant with the post consultation position.

Introduction

Background

14. In our draft Business Plan 2011/12 we said:

“It is increasingly clear to us that there are four core elements to effective regulation of the legal services market:

- An outcomes-driven approach to regulation that gives the correct incentives for ethical behaviour and has effect right across the increasingly plural and diverse market;*
- A robust understanding of the risks to consumers associated with legal practice and the ability to profile the regulated community according to the level of risk;*
- Supervision of the regulated community at entity and individual level according to the risk presented; and,*
- A compliance and enforcement approach that deters and punishes appropriately.*

We would welcome views on the appropriateness of these as the four pillars of regulation in order to further develop our thinking ahead of the final business plan.”

15. This paper explores further that section of the draft Business Plan and sets out in more detail the LSB’s emerging expectations and the rationale for enhanced requirements.

16. Much of the work that the Legal Services Board (LSB) has done in the 15 months since assuming our full powers has been focused on developing our strategic framework and, where appropriate, a more detailed approach to individual issues. We have also started to deliver the regulatory part of our role, making decisions on applications to change regulatory arrangements and starting to consider applications for new reserved legal activity designations and preparing for LAs. In future we may be required to approve new entrants.

17. Through this work, we make clear the approaches and standards that ARs are expected to deliver. This has allowed us to promote OFR and explain our expectations in terms of supervision and monitoring of authorised firms and

individuals. We have seen some developments, notably the new codes of conduct developed by the Solicitors Regulation Authority (SRA), the Council for Licensed Conveyancers (CLC) and ILEX Professional Standards Limited (IPS). The Bar Standards Board (BSB) and the Costs Lawyer Standards Board (CLSB) are engaged on similar endeavours.

18. But, as more of this type of work is completed, there is a risk that some of the existing ARs, by not changing their regulatory arrangements or altering their reach (such as through amendments to the list of reserved activities they can regulate) avoid scrutiny. They may continue to operate over a sustained time on a more prescriptive rules-based approach, rather than moving towards a risk based regime which would be more consistent with the Better Regulation Principles.
19. To avoid a “two-tiered” regime we need to develop a mechanism which will bring those regulatory arrangements that were “grandfathered” under the Act within the regime and to the required standards and so achieve consistency both within individual ARs and across the ARs as a whole.

What is the role of the Legal Services Board?

21. The LSB does not directly regulate legal services providers but instead is responsible for overseeing the regulation carried out by ARs. It is the ARs that have the role of regulating legal services providers across the different markets.
22. Section 3 of the Legal Services Act 2007 (the Act) imposes an obligation on the LSB to act in a way that is compatible with the eight regulatory objectives and to operate in the most appropriate way for achieving those objectives. The LSB must also have regard to the Better Regulation Principles under which regulatory activity should be transparent, accountable, proportionate, consistent and targeted only at cases where action is needed (s3(3)).
23. The same obligations are imposed on ARs (s28). It is certainly arguable that compliance with s28 can only be achieved with a risk-based regulatory regime as, unless the risks are uniform, any other approach is unlikely to be ‘targeted only at cases in which action is needed’ (s28 (3)). However, the extent to which an AR could deliver effective regulation on an alternative model must be for each AR to decide, bearing in mind their obligations under s28. Our proposals here set out the Board’s view on what is likely to be required,

establish the criteria against which that or any alternative approach might be assessed and set out the assessment framework.

24. The Act also requires the LSB to assist in the maintenance and development of standards of “the regulation by ARs of persons authorised by them to carry on reserved legal activities” (s4 (a)). It is clear from the explanatory notes to the Act¹ that part of the role of the LSB as an independent oversight regulator is to provide consistent and appropriate oversight of ARs and to ensure greater consistency of standards across the legal services sector.
25. Section 4 places a positive (not passive or purely responsive) responsibility on the LSB. “The Board **must** [emphasis added] assist in the maintenance and development of standards in relation to, (a) the regulation by approved regulators of persons authorised....”. We need to be satisfied that ARs are effective regulators which operate in a way that is consistent with the Better Regulation Principles. We do not agree, as has been suggested, that this means that we only assist where an AR asks or agrees that such assistance is needed. We also consider that section 4 must be read within the context of section 1, i.e. in discharging its functions the LSB must act in a way which it considers is most appropriate for meeting the regulatory objectives. There can be no doubt that the language of section 1 – “protecting”, “promoting”, “improving” with regard to the regulatory objectives - requires the LSB to be proactive.
26. We expect ARs to develop an outcome-focused approach to regulation. In our view that means more than having an outcome-focused code or handbook. The Board’s view, developed in this paper, is that an outcome-focused approach includes risk profiling, focused supervision and effective compliance and enforcement strategies: if any one part of this jigsaw is missing or defective the whole approach is undermined and unlikely to be effective. Through this discussion paper we are testing (and will subsequently develop) this as a foundation to our oversight of ARs and their regulatory regimes.
27. The LSB wants to focus on outcomes similarly. In terms of our oversight of ARs, we consider that by clearly identifying outcomes we are able to be transparent and target our resources at the areas of highest risk to those outcomes. This is not about full scale inspection of ARs by the LSB. But we need to put ourselves in an informed position so we step in to address a problem only if there are concerns about a regulator’s ability to address an issue (either individually or collectively).

¹ Legal Services Act 2007, Explanatory Notes, Section 2, paragraph 35

28. In delivering its regulatory functions the Board seeks to meet and promote the regulatory objectives. In being clear about its role, the Board is of course supporting the rule of law. Good regulation must be in the public interest and the Board has long argued that, properly targeted, the regulatory regime can also help secure a competitive market. Accordingly the approach set out in this paper underpins the full set of regulatory objectives.
29. The LSB has set out its objectives and processes in previous consultations, rules and business plans. These combine reactive processes that meet our obligations to consider certain applications; proactive interventions that will support the regulatory objectives such as opening up the legal services market through allowing ABS and strategic interventions that provide a (more or less prescriptive) context for regulators to develop their own approaches to certain regulatory objectives such as diversity.
30. These different approaches come together in three areas of our work:
- Approving new ARs and/or LAs
 - Approving the extension of reserved activities regulated by any existing AR or LA
 - Approving new and amended regulatory arrangements.
31. So far, our approach has been evolutionary. We have set high-level rules for processes required by the Act, whilst focusing these on outcomes rather than prescription where we consider it most appropriate. This has meant that regulators have had the freedom to design their own approaches to regulation which are compatible with the regulatory objectives and Better Regulation Principles. This is a strength that we must not lose when asking ARs to be explicit about how their regulatory regime meets the required standards. Our evolutionary approach has been effective since January 2010 and we expect that it will continue; but evolution is built upon change and learning from experience.
32. We recognise that, like the wider legal profession, our regulated community of ARs is diverse. It is not our intention to be prescriptive about how each AR must regulate - but in order to demonstrate that each is effective, we need to have a much better understanding of how they do regulate and the impact that this has on the experience of consumers in the relevant parts of the market.

Changing context for legal services and thus regulation

33. Professional self-regulation has many strengths. It is the foundation of the regulatory standards (and the professional principles) on which client confidence in the legal profession has been built. This confidence has allowed the legal services market to grow substantially over a sustained period and it remains, for many, a profitable business with many satisfied consumers. But professional self-regulation is recognised as unlikely to focus on efficiency and equity (or alternatively unlikely to correct producer/consumer asymmetry); it tends therefore not to lead to a market that reaches its most efficient or equitable size. This is explored more fully in the Regulatory Policy Institute (Decker and Yarrow) paper, *Understanding the economic rationale for legal services regulation*, Chapter 5 – The supply structure of legal services.²
34. Self-regulation has achieved its successes through a focus on high hurdles for entry - originally based upon an apprenticeship model, but increasingly based upon education and qualification requirements. Alongside those high entry standards, a common code of ethics or behaviour was put in place that gave consumers confidence about how their professional provider would behave. Any professional that did not adhere to the professional code of conduct faced punishment or exclusion.
35. The self-regulatory model emerged and developed more or less as part of a homogenous legal services profession. There has historically been a single way of practicing law as either a solicitor or barrister. That led to firms or chambers being remarkably similar in their structure, evolution, working practices and delivery models. The self-regulatory model has the profession in control of entry, standards of delivery, professional and firm behaviour, firm structure, external involvement and often even in controlling prices. It is a truly vocational model of delivering professional services and not a model that is primarily designed for competing for consumers in a dynamic market.
36. However, commercial and competitive pressures have grown over the last 50 or more years. Removal of the limit of the number of partners in a law firm in the Companies Act 1967 sealed the fate of any idea of a uniform professional services firm structure. Since then the number of partners in some firms has grown seemingly exponentially and, with that, a huge variety of business models, structures and practices have similarly proliferated.
37. It is not just firm size that has led to an increasing plurality amongst legal services businesses over the past few decades. Technological developments and capacity has grown across the economy and some law firms have

² Decker, C & Yarrow, G; "Understanding the economic rationale for legal services regulation", Regulatory Policy Institute, March 2011

embraced this in their business management process and consumer delivery models. Many others have not and remain sceptical of the commercial value in large scale investment. Perhaps linked to improvements in communications technology and certainly reflecting the needs and business models of their consumers, many law firms have grown to become international, whilst others remain small or rooted in local communities.

38. It may be that greater entrepreneurship within the legal profession led to some firms being more open to different ways of working or different opportunities than others. Regardless of the driver for change we can be sure that law firms look less like each other now than they did 50 years ago.
39. There is also no doubt that the recent recession has further intensified commercial and competitive pressures. For example, an enfeebled housing market impacts not just on standard conveyance transactions but also on legal work related to re-mortgages, new builds and buy-to-let. For firms that are heavily reliant upon the housing market the recession has presented huge challenges.
40. This recessionary pressure on revenue has been replicated in other areas such as commercial work at the mid-market and corporate end - evidenced by large lay-offs in some firms, mergers and even the collapse and closure of some firms.
41. Perhaps as evidence that no sector of the legal services market remains untouched we can see recent and planned changes to legal aid as continuing the intense pressure on the legal services sector. Combine a perceived lack of investment in technology, very small firms and hugely fragmented services with a political desire to reduce expenditure, and we have unfolding, perhaps, the largest upheaval facing legal aid providers in their 60-year history.
42. Added to the pressures highlighted above has been a reduction in the availability of bank finance and a reduction in capital in the insurance sector. It is no surprise that consolidation, restructuring and plurality are the pre-eminent themes that have been discussed. And it is not just the solicitor and conveyancer sector that is changing. Legal aid changes are impacting on the Bar and the search for greater value by other consumers is having a similar impact on those law businesses working with private business and other public sector bodies – and on the in-house legal advisers of those organisations.
43. The Bar is having to consider historic changes to practice models to gain work in criminal prosecution and defence, to establish panels and procurement

companies for local government work and to compete as chambers rather than individual barristers for much of their private work.

44. Greater consumer empowerment has also had an impact and this is perhaps most visible at the larger end of the legal services market where outsourcing and off-shoring are increasingly strongly established features of the legal services market. This is not just about other types of law firm being able to do some parts of a more expensive firm's work more cheaply. Recognition that much corporate advisory work is not actually reserved to lawyers is opening parts of the market to new types of business not owned or managed by lawyers. The twin influence of corporate counsel and both central and local government as bulk purchasers may be an emerging driver of much change in the legal services market.
45. Of course the regulated providers have always been open to potential competition on non-reserved services from non-lawyer owned businesses. In some areas such as will writing and tax planning in-roads into the legal market have been made by non-lawyers. But in most legal services external competitive pressure has remained latent as lawyers were barred from offering services to the public if working in a non-lawyer owned business and the public continued to value the solicitor brand. To date the commercial impact has been limited but the increasing opportunities that technology offers in legal services provision have seen some recent changes. On-line legal services are now growing into large businesses with the capital to invest, the brands to connect with consumers and the client flows that enable cross selling. Regulation must not restrict this competitive pressure without good cause, whether it is new entrants competing with regulated lawyers or, alternatively, regulated lawyers expanding their service offering to compete in wider markets.
46. The arrival of ABS is likely to sharpen the focus on unreserved services. A business only needs to be regulated if it is delivering reserved legal activities and as such any potential entrant will carefully weigh both the services it needs to deliver to (profitably) meet consumer demand and the cost of regulation. Whichever way new entrants jump, the competitive pressures are likely to increase.
47. Inevitably the focus is on large scale consumer facing legal services – corporate and personal. But the advent of multi-disciplinary practices and ABS makes any notion of one section of the legal services market remaining unaffected unlikely. From costs lawyers to patent and trade mark attorneys it is inconceivable that they can exist in separate silos. Already the majority of licensed conveyancers and legal executives work in multi-legal businesses; other parts of the profession are similarly seeing boundaries disappear.

48. This changing context for legal services can best be summed up as a gradual move away from a homogenous profession towards an increasingly plural legal services market. If the trend continues to grow and accelerate because of the combination of lower barriers to entry (for capital) and increasing potential from technology then we can expect greater and faster change in the future.
49. The Act, and thus the LSB, has a deregulatory focus in that it removes anti-competitive regulatory barriers to ownership. Paradoxically, of course, removing restrictions of itself can lead to significant amounts of secondary legislation: what has to be assessed is the impact of changes, rather than their volume. The LSB, like Parliament before it, sees the Act as a positive contribution to innovation, access to justice, choice and thus consumer benefit. But the Act does not simply deliver deregulation; it includes protections against the risks inherent in all legal services and against new risks that attach to deregulation. These include some legislative bulwarks, such as fitness to own tests and management and other structural requirements. Yet legislation can be a blunt instrument: it can only deal with the most egregious of threats and is hardly dynamic. Legislation is more effective when it provides a framework within which regulatory practice operates.
50. What is clear is that, as the legal services market has changed, the risks that it presents to the public and consumer have changed. Those risks do not appear to be dependent on the ownership model adopted, but it would be naive to assume that the greater flexibility introduced as a result of ABS will have no impact on the risk profile of the industry. Some might highlight the miners' compensation cases as evidence of increased problems or perhaps of the visibility and impact of poor behaviour when on a large scale. Others might stress that the commercial and competitive pressures have increased the threat to consumers. Regulation of course must be able to identify the real risks and regulate in a manner that keeps pace, encourages, supports and controls these changes so as to underpin the regulatory objectives. In the next section we explore what sort of modern regulation may be fit-for-purpose.

Question 1

Do you agree with our analysis of the changing legal services market? Are there other factors that should be taken into consideration?

What sort of regulation does the LSB expect from ARs?

51. The LSB's thinking on how a modern day regulator should perform is, naturally, founded in the need for the LSB and ARs to act in a manner compatible with the regulatory objectives. The Better Regulation Principles (transparent, accountable, proportionate, consistent and targeted) play a key role in guiding our approach and we seek to learn from the experience and good practices of other regulators.
52. Below we set out what the Board considers to be the key elements of a regulatory regime that meets the statutory requirements of the Act. As mentioned above, we consider that an outcome-focused approach relies as much upon the identification and supervision of risk as it does the setting out of a code or handbook that starts with principles or outcomes. There is little point in having consumer friendly outcomes that offer providers freedom to operate their businesses if the day to day interaction between regulators and regulated is rules based and not responsive to actual risks. It is against these four elements of effective regulation that the Board would like to assess ARs, using the criteria that are proposed at Annex 1. Moreover, underpinning all of this is the capability and capacity to deliver; supervision is as much about the regulator as it is about the regulated.

Outcomes-focused

53. The LSB has already nailed its colours to the mast of OFR. In our discussions with ARs which wish to be designated as LAs we have made clear the importance of outcome-focused regulation and the Better Regulation Principles. These are important steps away from the "permissions based" approach that prevents all behaviour unless it is shown to be safe. An outcomes-based approach combines flexibility, responsibility and accountability for legal services providers – it is they that must secure the regulatory outcomes and decide how their firm will do so. We do not underestimate the scale of change required from both ARs and the regulated community to deliver OFR.
54. For regulators, OFR is crucial in as much as it recognises the plurality that has emerged in the legal services market. It would be resource intensive, if not impossible, to design a set of detailed rules that works for each and every type of firm. As has been seen in recent years with solicitor conflict rules, a one size approach has simply not coped with the developing business structures and practice in conveyancing, corporate work and elsewhere.

55. In setting outcomes, the ARs must go further than simply meeting consumer expectations. Regulation does not put restrictions on business simply because consumers prefer it; rather it exists to protect certain outcomes that Government, Parliament and, in the case of legal services, the Judiciary decide warrant protection. Thus the regulatory objectives in their entirety need to be reflected in the outcomes upon which regulation is based. Regulators must always be able to show the basis and evidence upon which their outcomes are set.
56. The pursuit of outcomes is part of the shift towards a consumer focus. Ensuring that regulation is focused on consumers must be based upon a proper understanding of consumers and their expectations. The LSB's work on consumer outcomes³ will provide a foundation for the whole sector but that will need to be complemented with sector specific work to identify appropriate outcomes for each regulator.
57. An outcomes-based approach, with responsibility for compliance falling on the regulated community, is not a pure deregulatory approach. The Act provides very clear boundaries in terms of the regulatory objectives at the highest level and more detailed prescription elsewhere (such as ownership of ABS or rules requiring the holding of professional indemnity insurance).

Risk identification framework

58. Once the regulated community has freedom to operate in the manner it chooses to deliver compliance with the outcomes-based codes, it becomes increasingly important that the regulator focuses on the parts of the regulated community that present the greatest risk to the outcomes. As we explored earlier, in a changing market the plurality of business and delivery models means that risk is neither evenly spread nor fixed. A risk-based approach helps regulators move ahead of the curve – away from writing rules for things that have already happened and closer to mitigating risk.
59. Regulators will need to show that they have a framework in place for identifying risk. This will operate at the level of the overall regulated community; different business, ownership and management structures; financial issues and size of entity or firm; range of services; individual practitioners; consumer segments; workforce skills, knowledge and experience; and, other factors as appropriate. They will need to update this regularly and have systems for identifying trends and changes in the risks.
60. In addition to the identification of risks themselves, ARs must have systems for profiling each regulated entity (and individuals) and tracking changes in

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http://www.legalservicesboard.org.uk/news_publications/latest_news/pdf/consumer_outcomes_final_research_report.pdf

risk profile over time. Again, this will need to operate at the individual, entity and thematic level to properly and proportionately capture and mitigate risk.

61. Such an approach will allow ARs to ensure that regulation remains proportionate to actual risk within a plural and diverse market.

Proportionate supervision

62. In LSB terms, supervision is about the day-to-day activities that regulators undertake in relation to their regulated community. It includes setting the standards and requirements for entry; determining the standards and behaviours for those who are regulated; and undertaking appropriate reviews, based on an assessment of risk, to provide assurance that those standards and behaviours are achieved and maintained. To deliver this, regulators need a range of tools (e.g. returns, random and planned site inspections, thematic reviews) to allow them to give that assurance.
63. As an oversight regulator, the LSB will need to use a range of regulatory tools to be assured about its regulated community of legal services ARs. The intensity of the supervision will vary depending on the risks that each AR presents to the achievement of the regulatory objectives.
64. Having a clear and evidence-based risk system allows a regulator to target resources on those businesses, individuals, sectors and issues that present the greatest risk to the regulatory objectives and consumer-focused outcomes. That, combined with the duty across all of the regulatory community to take responsibility for their own compliance, shifts the focus of regulatory activity away from compliance with detailed rules towards supervision of the most significant risks.
65. For this to be effective, ARs must be able to profile the regulated community – and regulated activities – by risk and group accordingly. A high risk firm is not necessarily one that is doing something wrong – it simply means that the likelihood of not delivering outcomes is higher or more significant. Thus a firm that is facing financial challenges may be high risk alongside a firm that is working only with highly vulnerable consumers.
66. This is not about creating a “zero risk” environment. Innovation, change and certain types of work carry greater risks but the key is to ensure that there is close management and mitigation by firms so that the likelihood of the risks occurring is reduced to an acceptable level. An AR’s supervision should take into account what steps a firm has put in place to manage their own risk profile and develop its regulatory approach accordingly. This will benefit firms as it will allow them to develop their business in the changing legal services

market. It will contribute to increased confidence among consumers in those areas that are perceived as higher risk.

67. The parts of the regulated community that are profiled as lower net risk (i.e. the assessment after considering how risk is managed and mitigated) should benefit from less intensive supervision. But, of course, they will have no greater or lesser freedom to deliver services that do not compromise the regulatory outcomes and the duty to remain compliant with the specified outcomes will act as a boundary for those firms. Even without close supervision, they are unlikely (especially so given that they are classed as lower risk) to transgress – that is the nature of being lower risk – but an effective enforcement strategy should assist in those businesses living up to their low risk categorisation.
68. Firms set culture, process and direction for individual staff. Thus supervision of the regulated community must operate at the entity level as well as the individual. It will be for the AR to decide the appropriate balance between entity and individual supervision based upon the actual risks.
69. A supervisory regime must operate at the authorisation stage as well as providing ongoing supervision. This may be through education and qualification requirements for individuals through to any number of factors for entities such as financial stability, insurance requirements or transparency of ownership.
70. ARs will therefore need to demonstrate not just systems and process but also capacity and capability to supervise effectively. This will include demonstrating that they have financial resources to secure and maintain adequate people, systems and controls.

Appropriate enforcement strategy

71. Of course no regulatory approach can guarantee that the whole regulated community will continue to operate without error or transgression. Regulators therefore must have an enforcement strategy that incentivises and encourages compliance, deters non-compliance and punishes transgressions appropriately.
72. Deterrence is an important element of any enforcement strategy. The strategy must cater for a range of effective sanctions that serve not only as a punishment but are capable of acting as a deterrent to the wider regulated community and so contribute to the attainment of better compliance overall.

73. To be effective the enforcement process must be flexible. Thus it needs to be capable of moving quickly and retaining its focus on high quality investigation and decision-making. It should also be able to address issues at entity and individual levels as appropriate – both may well be needed in some cases.
74. For enforcement to build confidence amongst all stakeholders it must be credible – that is simple, fair and swift.

Question 2

Do you agree with our focus on outcomes focused regulation; risk identification framework; proportionate supervision; and, appropriate enforcement strategy?

Question 3

How do you think that a more flexible and responsive regulatory regime should be developed?

Implementation

75. ARs will be expected to ensure that there is effective translation of all the above into their regulatory operations in their specific context. As oversight regulator, the LSB will expect ARs/LAs to demonstrate that it is happening in practice – and to be clear about how they will measure that it is having a demonstrable effect on behaviour and/or public confidence as appropriate.
76. The detail of how to deliver effective regulation is a matter for each AR/LA. The LSB recognises that not each AR/LA will regulate the same set or range of risks, so the regulatory frameworks will vary. Therefore each will need a different balance between the available supervisory tools depending upon the nature of the market and risks that are being regulated; but implementation has to be based upon the obligation to deliver the regulatory objectives rather than any professional preference.
77. For the Board to be confident that regulation is operating to ‘better regulation’ standards and delivering the regulatory objectives it will need to not only see the rigour with which systems are designed but also the competence of the organisation to deliver. Thus the Board will want to consider the capability and capacity of each AR.
78. These proposals have been informed by the LSB’s experience of regulatory decision-making during 2010 and from its ongoing consideration of applications made or being prepared (such as IPS’ applications to extend its

reserved activities and SRA's and CLC's LA applications). In effect these are emerging as part of our regulatory decision-making, but have not been set out as explicit criteria.

79. The LSB may need to consult on amendments to certain of our own rules for considering applications (such as approval of amendments to regulatory arrangements, approval of new ARs and LAs and extension of existing AR/LA reserved legal activities). Further analysis of the most effective route will be undertaken, subject to the LSB setting out the overall direction after this consultation.
80. It is proposed that the standards in this paper should be further developed and phased in over a 12-month period. That would allow them to be used to support decision-making in existing applications without being an 'unfair late addition' to the rules. It would also allow ARs that have not yet embraced this approach time to move towards better regulation.
81. To assist this, LSB proposes, once the overall approach has been settled, to invite each AR to conduct a simple self-assessment of its regulatory approach against this high level model, including the criteria at Annex 1. We would not object should ARs wish to inject some external scrutiny into the process, although it is the relevant AR Board that will be expected to provide assurance. We are proposing a self-assessment based methodology as, first and foremost, this gives the Board of each AR the responsibility for reviewing, amending and justifying its approach rather than assuming that the LSB as the oversight regulator has a fully worked up "correct answer" to test ARs against. Furthermore this approach is working well in relation to our internal governance rules. The self- assessment would be the basis for a supervisory discussion between the LSB and each AR, consistent with the LSB as role as 'overseer' rather than 'direct regulator', leading to an agreed action plan for the AR to develop its own regulatory model. The LSB's supervision can then be focused on monitoring progress against the agreed plan.

Question 4

We would welcome views on whether self-assessment is an appropriate approach or whether LSB should deliver its oversight by conducting its own reviews?

82. The self-assessments may, collectively, identify areas that might be considered for thematic reviews in our 2012/13 and subsequent Business Plans, or indeed areas for more immediate consideration.

83. The LSB will use its approval processes to encourage and ensure compliance. Thus any AR making an application to amend its regulatory arrangements, extend its reserved activities, become an LA, or indeed enter as a regulator for the first time, would need to show how it met the LSB's expectations.

What do ARs gain from this approach?

84. There are a number of potential benefits to ARs from this approach:
- More clarity from the LSB on what the Board expects from ARs. Frontline regulators can plan their regulatory modernisation programmes rather than deal with issues as they are raised by the LSB
 - The LSB should develop more confidence in ARs' ability/effectiveness as a regulator. This should lead to less intrusion/questioning and ultimately reduce the risk of LSB micro-management – subject, of course, to standards being maintained and reported on
 - Effective forward-looking risk assessment so that ARs can, and will, be seen to take appropriate action to mitigate against the big risks actually occurring - rather than managing compliance primarily against codes or handbooks
 - Regulatory action focused on risks to the regulatory objectives. This can mean less net risk to individual consumers and increased confidence in regulation
 - Outcomes-focused codes should ensure that compliance is related to actual risks rather than 'one size fits all' checklists. This, and the associated increased flexibility for law firms, could reduce compliance costs for firms
 - Because an outcomes-focused approach means fewer prescriptive rules there is less of a need to change the rules as circumstances change - and an associated reduced need for LSB rule change approval
 - Overall a body of evidence will develop from which assurance can be gained on the effectiveness of legal services regulation.

What are the risks to ARs in undertaking the changes to become modern regulators?

85. The full implementation of the Act initiated a period of significant change for legal professionals and their regulators. The LSB believes that it has a responsibility to set out what is expected from legal services regulators and recognises that this has uncertainties and potential risks:

- Do the ARs have the skills, resources and ability to deliver?
 - What is the cost to ARs (and the regulated communities) of modernising regulation?
 - Are the benefits greater than the costs?
 - What impact would this change have on ARs' other priorities?
86. We do not underestimate the scale of change that will be needed from the ARs but to do nothing creates the risk that the approach to regulation stifles innovation in firms which wish to take full advantage of the opportunities that the Act brings. Furthermore, to do nothing is unlikely to meet the tests that the LSA 2007 sets for the LSB and ARs: much of the current regulatory regime could not be described as promoting the regulatory objectives or upholding the better regulation principles.

Question 5

What are your views on the benefits, costs and risks to ARs and their regulated communities of our proposals?

Conclusion

87. We have a unique opportunity to embed Better Regulation Principles as required by the Act. The pace of change in the legal services market is unlikely to slow and the resulting plurality of business structures and service delivery is unlikely to reduce. This is the right time for the LSB to set out a baseline approach to regulation and review ARs' performance against those standards.

Next Steps

88. While this is not a new initiative from the LSB, it is perhaps the first time that our approach has been articulated in one place. We recognise that some ARs are more advanced in their thinking and developments and that we need to agree with each individually how they will respond to this paper. We are keen to discuss this paper with all ARs and what it may mean for them.
89. The next steps are as follows:
- to invite feedback from all ARs and other interested parties by 12 July 2011
 - in the light of the feedback, to develop appropriate indicators and criteria of regulatory standards describing models of good and bad approaches for each. An initial draft of the criteria has been included on Annex A
 - to publish a self-assessment process including how compliance will be measured and poor regulatory standards addressed during September 2011
 - each AR to undertake a self assessment against the criteria and agree with the LSB an plan for any areas requiring action by December 2011
 - to review our own existing rules, procedures and guidance.

Question 6

We would particularly welcome feedback on the criteria at Annex A, including suggestions on others that might be appropriate.

How to respond

Views on our proposed approach are welcome by 5 pm on Monday 11 July 2011. The consultation period will be over 12 weeks.

In framing this consultation paper we have posed specific questions to help inform our final decision. These questions can be found in the body of this consultation paper and also as a consolidated list at Annex B. We would be grateful if you would reply to these questions, as well as commenting more generally on the issues raised (where relevant). Where possible please can you link your comments to specific questions or parts of the paper rather than making general statements.

We would prefer to receive responses electronically (in Microsoft Word or pdf format), but hard copy responses by post or fax are also welcome. Responses should be sent to:

Email: consultations@legalservicesboard.org.uk

Post: Michael Mackay,
Legal Services Board
7th Floor, Victoria House
Southampton Row
London WC1B 4AD

Fax: 020 7271 0051

We intend to publish all responses to this consultation on our website unless a respondent explicitly requests that a specific part of the response, or its entirety, should be kept confidential. We will record the identity of the respondent and the fact that they have submitted a confidential response in our decision document.

We are also keen to engage in other ways and we would welcome contact with stakeholders during the consultation period.

Complaints and queries

Complaints or queries about the LSB's consultation process should be directed to Michelle Jacobs, Consultation Co-ordinator, at the following address:

Michelle Jacobs
Legal Services Board
7th Floor
Victoria House
Southampton Row
London WC1B 4AD

Or by e-mail to: michelle.jacobs@legalservicesboard.org.uk

Glossary of Terms

ABS	Alternative Business Structures. From October 2011 non-legal firms will be able to offer legal services to their customers in a way that is integrated with their existing services. Or law firms will be able to develop their portfolios to compete across wider areas compared with their existing experience.
AR or approved regulator	A body which is designated as an approved regulator by Parts 1 or 2 of schedule 4, and whose regulatory arrangements are approved for the purposes of the LSA and which may authorise persons to carry on any activity which is a reserved legal activity in respect of which it is a relevant AR
BSB	Bar Standards Board – the independent regulatory arm of the Bar Council
CLC	Council for Licensed Conveyancers – the regulator of Licensed Conveyancers
Consultation	The process of collecting feedback and opinion on a policy proposal
ILEX Professional Standards Board	Institute of Legal Executives Professional Standards Board – the independent regulatory arm of the Institute of Legal Executives
LA or Licensing Authority	An AR which is designated as a licensing authority to license firms as ABS
LSB or the Board	Legal Services Board – the independent body responsible for overseeing the regulation of lawyers in England and Wales
LSA or the Act	Legal Services Act 2007
Principles of Better Regulation	The five principles of better regulation, being proportional, accountable, consistent, transparent and targeted
Regulatory Objectives	There are eight regulatory objectives for the LSB that are set out in the Legal Services Act (2007): <ul style="list-style-type: none"> • protecting and promoting the public interest • supporting the constitutional principle of the rule of law • improving access to justice • protecting and promoting the interests of consumers • promoting competition in the provision of services in the legal sector • encouraging an independent, strong, diverse and

	<p>effective legal profession</p> <ul style="list-style-type: none"> • increasing public understanding of citizens legal rights and duties • promoting and maintaining adherence to the professional principles of independence and integrity; proper standards of work; observing the best interests of the client and the duty to the court; and maintaining client confidentiality.
Reserved Legal Activity	Legal services within the scope of regulation by the Approved Regulators
SRA	Solicitors Regulation Authority - Independent regulatory body of the Law Society

Annex A: Key indicators of, or criteria for, regulatory standards

Outcomes-focused regulation

- Outcomes that consumers should experience are the basis of codes of conduct and behaviour of authorised persons.
- Recognises the public interest in legal services as part of the wider justice system.
- Guidance is clearly discretionary and does not unnecessarily restrict firms in how they deliver the outcomes.
- Education and training standards (both at entry and on an ongoing basis) ensure that appropriate standards are achieved and maintained, and encourage diversity in the profession.
- Effective advisory services for regulated entities and individuals.

Risk assessment

- Focus on entity as well as individuals.
- Formalised approach to risk assessment which is transparent.
- Responsive to changing conditions.
- Collection of data set and other information to determine the risk assessment.
- Should be capable of picking up individual and firm specific issues as well as wider profession issues.
- Forward looking as well as assessing risks from current data.
- Outputs determine supervision activity – themes, intensity, frequency and form.
- Regular reassessment of risks based on lessons from regulation and wider environmental scrutiny at Board and senior management levels.

Supervision

- Activity and precise tools used determined by risk assessment outputs.
- Proactive as well as reactive.

- Forward looking plan of activity – focused on risks; flexible; reports produced on the progress against the plan, the findings and issues.
- Responsive to changing conditions.
- Thematic as well as firm specific.

Enforcement

- Predominantly targeted at breaches that are serious and undermine the regulatory objectives (perhaps alongside a set of more administrative penalties).
- Incentivises and encourages compliance.
- Fast and fair.
- “Remedial” options available in less serious cases.
- Deterrent as well a punishment.
- Appeals process.
- Publicity (important for deterrence).
- Enforcement policy that sets out the approach.

Capacity and capability of ARs to deliver regulatory standards

- Clear understanding of the different areas that the regulator is responsible for.
- Proper level of resource and people – linked to the number of people / firms to be supervised and nature of risks presented Clear definition of skill sets; role profiles.
- The right capability and capacity across the regulator.
- Clear governance processes, systems and controls and evidence of their operation.
- (Independent) assessment of effectiveness, underpinned by clear management information.
- Compliance with IGRs.
- Clear mechanisms for consumer engagement in policy making processes.

- Effective Board, challenging and holding Executive to account, rather than being involved in supervisory decisions or micro-management of practice development.

Annex B: A list of questions raised in this document

Question 1

Do you agree with our analysis of the changing legal services market? Are there other factors that should be taken into consideration?

Question 2

Do you agree with our focus on outcomes focused regulation; risk identification framework; proportionate supervision; and, appropriate enforcement strategy?

Question 3

How do you think that a more flexible and responsive regulatory regime should be developed?

Question 4

We would welcome views on whether self-assessment is an appropriate approach or whether LSB should deliver its oversight by conducting its own reviews.

Question 5

What are your views on the benefits, costs and risks to ARs and their regulated communities of our proposals?

Question 6

We would particularly welcome feedback on the criteria at Annex A, including suggestions on others that might be appropriate.